Focus on Markets

Ulster Bank

- Central banks have dramatically stepped-up their policy response to the crisis, in the process engineering a growth-supporting improvement in financial conditions
- Now it's time for political leaders on both sides of the Atlantic to do likewise as recovery prospects depend importantly on reducing key uncertainties
- Whoever is the new US President will need to make early, rapid progress on navigating the 'fiscal cliff'
- While euro area leaders need to show more urgency in advancing their plans for deeper integration
- The danger is of slow, patchy and inadequate progress, especially in Europe, which means that the macro outlook continues to face downside risks as we head into 2013
- The euro remains vulnerable to such risks (including possible renewed concerns about 'Grexit'), and may slip back to $1.25 and 78p in coming months

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5th November 2012

Overview

There has been a notable gear-shift among a number of the world's major central banks as they seek to make maximum use of the monetary policy toolkit in order to address the interrelated problems of weak and fragile economic activity and elevated macro-financial risks.

The ECB under Mario Draghi has become visibly more proactive and determined in its approach to the management of the crisis. In his twelve months in charge, the ECB has implemented three rate cuts and two 3-year LTROs, while most recently it has unveiled the Bank's Outright Monetary Transactions (OMT) programme, the latter initiative having particular significance as it provides a badly-needed backstop for euro area sovereign debt markets, under appropriate conditionality. Mr Bernanke's Fed continues to live by the mantra of 'whatever it takes', with its latest initiative involving the unprecedented step of announcing an open-ended asset purchase programme to support financial conditions and a stronger recovery in the US. The Bank of England, under the leadership of Mervyn King, has also continued to provide more stimulus, supplemented by the Funding for Lending Scheme aimed at boosting UK credit availability.

To their credit, central bankers have succeeded in engineering a clear improvement in financial conditions in recent months as their actions have generally boosted financial asset prices and lowered concerns about potentially destructive economic and financial tail risks. The result is that financial conditions are now providing a very helpful tailwind for US growth prospects as we move through the end of the year and into 2013. Trends in euro area financial conditions have also improved and have transitioned from growth-sapping levels during the summer as equities weakened and credit and sovereign spreads widened, to levels which, for the first time in over 5 years, are broadly neutral for the economy.

Nevertheless, the US recovery remains unsatisfactorily weak, evidenced by sub-par job creation and still elevated levels of, though declining, unemployment. The situation is worse in the euro zone which has slipped back into recession and where the unemployment rate stands at record highs and continues to rise. While balance sheet recoveries always tend to be weaker and more gradual than typically is the case, in our view the present recovery is also being held back by a larger-than-usual amount of uncertainty, at least some of which can be directly laid at the door of ineffectual policy-making by political leaders.

In the euro zone, important agreements were reached at the June and October EU leaders' summits which pave the way for the creation of a banking union and the possibility to finally break the negative feedback loops operating between sovereign and bank funding markets. However, a key first step is the establishment of a single supervisor mechanism, while moves are also required in relation to a zone-wide deposit guarantee insurance scheme and an agreed framework on bank resolution. Progress on implementation in these areas has lacked urgency as it again appears that political leaders struggle to take timely policy decisions in the absence of the pressure of highly strained market conditions. In the US, the economy faces a $600bn-plus 'cliff' of fiscal tightening measures in the absence of a political agreement on how to address the unsustainably large budget deficit.

In both cases, the resulting uncertainty has had clearly-damaging impacts on economic confidence and activity. It is no coincidence that the weakest performing area of the euro economy over the past year has been investment. Economic decision-makers have faced a huge amount of uncertainty, not only about future demand within and outside the euro area in the context of a lacklustre global recovery, but also uncertainty about the very survival of the euro area itself in the face of crisis policy-making by European leaders that has consistently been substandard in both its formulation and implementation. Business investment trends have also weakened sharply in the US in recent months, as firms have pulled back in the face of uncertainty about the size and nature of their future tax liabilities and other policy-related business costs as well as about the possibility of adverse regulatory reforms.

With monetary policy in the major economies already extremely accommodative and stretching the limits of what can reasonably be expected from central banks, the economic outlook hinges to a larger degree than normal on policy choices and outcomes within the realm of political leaders.

That is not to say that we think the work of the central banks is now complete. In fact, we look for the Fed to announce a further extension of its programme of purchases of longer-term securities next month. In addition, it looks to us as if the euro zone economy's run rate is likely to fall short of prevailing ECB expectations in the coming months, thus building the case for a possible rate cut next year, while other policy options including a further easing of its collateral rules and potentially additional LTROs. In the UK, the Bank of England continues to stress that it will provide more stimulus if needed, though recent news on Q3 GDP was better than expected, reducing the chances of another monetary boost in the short term.

However, arguably, the strongest contribution to growth which economic policy making can make at present would be for senior political figures to show strong decisive leadership in addressing key policy uncertainties. In Europe, that means rapidly advancing and implementing plans for deeper integration. Swift, concrete progress would serve to underpin policy initiatives implemented to date and therefore boost policy credibility, reduce related uncertainty about the survival of EMU, and bolster confidence among economic agents within and outside the euro zone.

In the US, one of the first critical tasks facing the new President will be to achieve political agreement on ways to avoid the full impact of the fiscal cliff in the near-term. Beyond the pressure point of the cliff, the imperative will be to formulate a credible, implementable plan that will assure a sustainable path for the US public finances over the medium term, and to set out a clear vision on proposed regulatory reforms.

While some degree of fiscal tightening is inevitable in the US next year, we do think that political leaders will agree the necessary compromises to avoid the full effects of the cliff. After all, what President or party will want to be associated with the blame for having induced an avoidable recession?

In Europe, recent past performance suggests it would be imprudent to count on anything beyond gradualism from political leaders. Our base case does anticipate that further progress will be made in the direction of deeper fiscal and financial integration - a scenario that should allow for a slight improvement in growth performance next year. However, the danger is of slow, patchy and inadequate progress in key policy areas, which means that the euro zone macro-financial outlook continues to face material downside risks as we head into 2013.

Concern about such downside risks in general, and the scope for 'Grexit' risks to resurface in particular, leaves us cautious on the prospects for the euro's performance on the currency markets in coming months. We anticipate that the single currency will slip back towards the $1.25 and 78p levels vs. the dollar and sterling respectively in the coming months.

Similarly, the likelihood of a bout of renewed market tensions linked to the euro crisis is likely to see long-term rates come under renewed downward pressure early next year, and we anticipate 5-year swap rates for example, will revisit their recent all time record lows of close to or below 1% across euro, sterling and dollar markets. However, we expect long-term rates to rise over the course of the year, as policy uncertainties and concerns about downside macro-financial risks ease to a degree.

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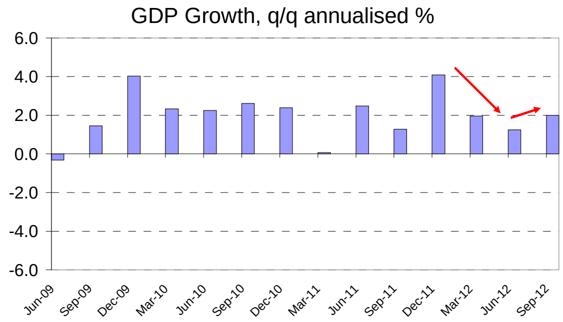
Forecasts (end period)						
	Latest	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13
Interest Rates						
Eur						
ECB Refi	.75	0.75	0.50	0.50	0.50	0.50
5yr Swap	0.9	1.0	0.8	0.9	1.2	1.7
US						
Fed Funds	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25	0-0.25
5yr Swap	0.8	0.9	0.8	1.0	1.5	2.0
UK						
Bank Rate	0.50	0.50	0.50	0.50	0.50	0.50
5yr Swap	1.1	1.1	1.0	1.1	1.3	1.8
Currencies						
EUR/USD	1.29	1.32	1.25	1.25	1.25	1.25
EUR/GBP	0.80	0.81	0.78	0.79	0.80	0.81
GBP/EUR	1.25	1.23	1.28	1.27	1.25	1.23
GBP/USD	1.61	1.63	1.60	1.58	1.56	1.54
EUR/JPY	1.29	1.32	1.25	1.25	1.25	1.25

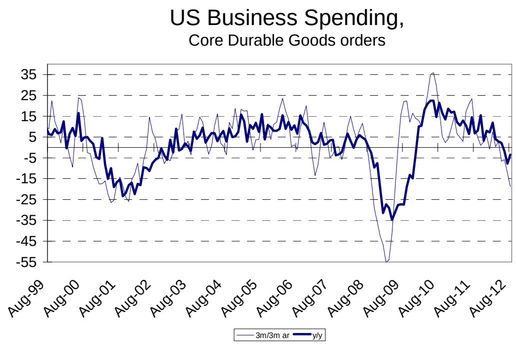
The US Economy and Fed Outlook

The US economy lost momentum over the first half of the year. While growth picked up a bit in Q3, the recovery has been disappointingly sluggish…



The macro data out of the US over the first half of the year show a clear weakening in the momentum of the economy's recovery. The economy grew by 1.3% on a quarterly annualised basis in Q2, representing a slowdown from the 2% annualised pace recorded in the first quarter and and the 4% pace of expansion in the last quarter of 2011. Some of the slowdown in the first half of this year can be attributed to a reversal of higher than usual activity during the winter months (owing to the milder temperatures during the Winter). And while the most recent figures show a slight pick up in GDP growth to a 2% pace in Q3, the overall picture has been one of positive, but disappointingly sluggish, growth this year.

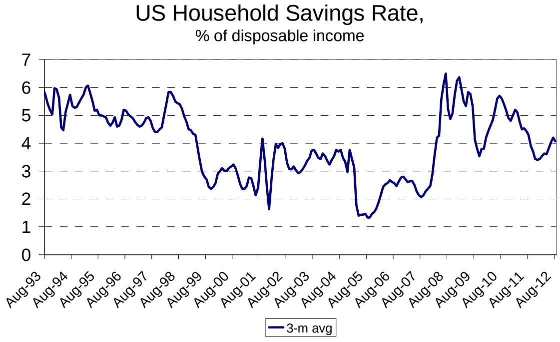
The high degree of uncertainty in the economy has acted as a drag on business spending…



A key factor and cause of the weakening momentum is the air of 'uncertainty' that currently exists in the economy. This uncertainty is fuelled by various sources, including the issue of the fiscal cliff, the subdued pace of labour market improvement, the upcoming presidential elections, the regulatory environment for business, the lack of a solution to the euro zone debt crisis, as well as increasing concerns of a slowdown in emerging market economics and the negative implications this would have for the already fragile global economy. This high degree of uncertainty has led to both consumers and businesses delaying and reducing economic activity. Businesses appear to be holding back on spending, with the most recent GDP and durable goods figures showing an outright decline in business investment in areas such as Equipment and Software. While some of this weakness in business investment reflects a slowdown in the global economy, there is no doubt that increasing uncertainty is having a negative drag on business investment. While consumer spending continues to contribute to growth, there does appear to be some level of a dampening impact from a higher savings rate. In the second quarter, the pace of consumer spending slowed from an annualised 2.4% q/q in Q1 to 1.5% in Q2, representing its slowest pace of growth in a year. Even if some of the key areas of concerns and sources of uncertainty do not come to pass, the altered economic activity behaviour on the part of consumers/businesses encompasses a self fulfilling element to the concerns and uncertainty in relation to the economic outlook.

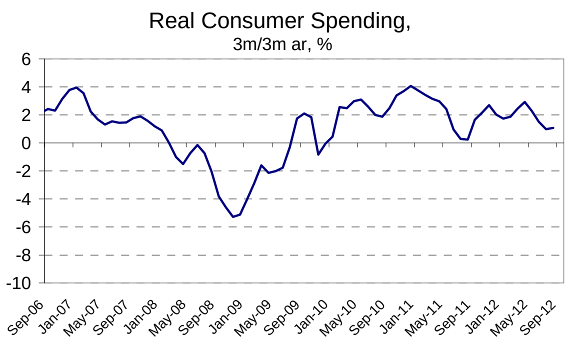
One area of the US economy which has provided some encouraging signs has been the much maligned housing sector. In previous recovery scenarios for the US economy, the housing sector has been a key driver of the underlying improvement in the economy. This time around however, given the origin of the downturn originated in the housing market and the resulting credit crunch meant that the housing market was not in a position to drive the economy forward. However, in recent months, the housing market appears to have turned the corner. The sector underwent a significant correction process from both an activity and price perspective. This correction process looks to have passed, helped by the modest improvement/healing in the economy generally and also by an improvement in credit conditions. US Home builder confidence is now at is highest level since mid 2006. House prices are on the rise, existing home sale prices are over 12% higher year to date. Housing activity is being boosted by increased homebuilder confidence as well as rising prices, with housing starts up by around 8% in the eight months to August and the housing sector is making a consistent positive contribution to economic growth.

…this uncertainty is also impacting on consumers, with upward pressure on the savings rate…



While the housing sector now constitutes a smaller percentage of GDP, with total residential investment currently accounting for c.2.5% of real GDP, down substantially from a peak of around 6% in 2005, there are important indirect benefits to the economy, aside from the fact that the sector is no longer a drag to economic growth. One of these important impacts is the positive influence that increasing house prices can have on consumer spending, arising from a wealth effect, as well as the boost generally to consumer sentiment. Within the housing sector, increasing house prices can prompt potential buyers to buy now before prices increase further, which in turn may help to provide a boost to ground breaking activity and in the process increase the contribution that the housing sector makes to economic growth.

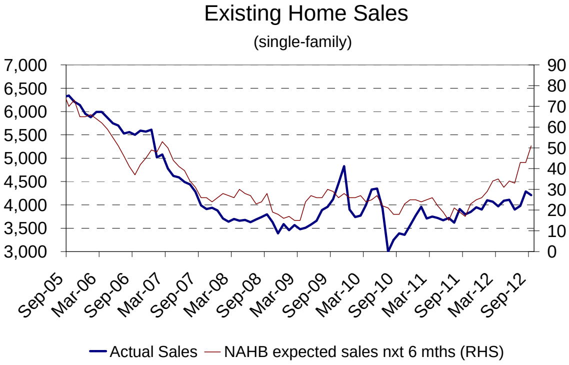
…higher savings rate is having a dampening impact on consumer spending…



While the housing sector has provided some positive news, the pace of improvement in the US labour market continues to provide a key source of concern and headwind to the economy's growth prospects. The most closely watched indicator on the US labour market, the nonfarm payrolls data has averaged growth of around 150k per month so far this year. The expanding employment levels have been associated with some small declines in the unemployment rate, which is currently at 7.9%. However, while the data is reflecting slight improvement in labour market conditions, the pace of improvement is falling short of what is needed to make meaningful inroads into the spare capacity that exists in the labour market. The labour market is a key variable in the performance of consumer spending and to the overall economy's performance given the fact that consumer spending constitutes roughly 70% of the economy. The sluggishness in the labour market has played a role in the ongoing cautiousness on the part of the US consumer. Another impact from the slow pace of labour market improvement has been felt on earnings and the modest pace of increases there, which has played a role in preventing a more robust performance from the consumer side of the economy.

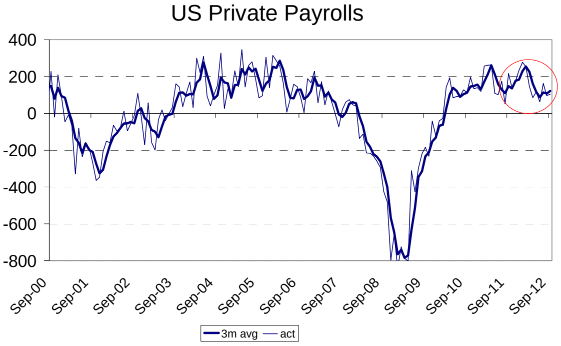
Indeed it is this sluggish nature to the recovery and in particular the slow pace of improvement in the labour market or in Chairman Bernanke's words his 'grave concern' over the 'employment situation', that prompted the Federal Reserve to act yet again in recent weeks. At its September meeting, the Federal Reserve announced further monetary stimulus to help 'quicken' the recovery in the US economy. These measures are probably the most aggressive stimulus actions ever announced by the Fed. As part of its decision to launch a third round of asset purchases (i.e. QE3), the Fed will be injecting an additional $40bn of money into the US economy each month through purchases of mortgage backed securities. However, unlike previous QE programmes, this round of QE is open ended, with no defined limit on the timeframe and therefore no limit on the actual total amount of purchases. In addition to these ongoing asset purchases, the Fed also provided further monetary stimulus to the US economy through its communication tools by extending out its forward guidance on interest rates. The Fed now states that interest rates will remain at exceptionally low levels to 'at least through mid 2015' from its previous guidance of 'at least through late 2014.

…US housing sector appears to have turned a corner…



These new stimulus actions were welcomed by the market and helped fuel a rally in risk assets. However, amidst the market euphoria it is important not to lose sight of what these actions illustrate in terms of the Fed's view of the performance of the US economy. Specifically the aggressive policy response from the Fed shows the level of concern within the Fed over the sluggish pace of growth in the economy. Indeed, the Fed has not just put in place an open ended asset purchase programme, it has for the first time tied policy intervention to improvements in the labour market and guided that it will not reverse this stimulus policy until it has achieved its aim of a more substantial improvement in the labour market.

…however, the pace of improvement in the labour market remains sluggish…

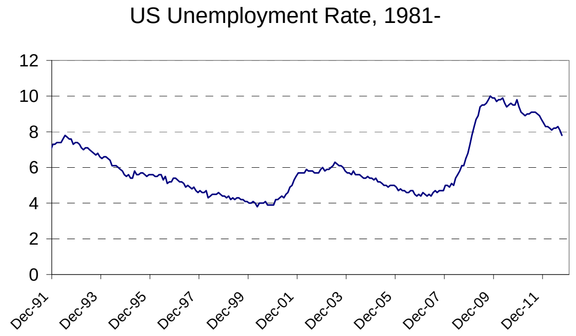


On the issue of the specific conditions that would lead to the Fed to stop buying bonds, Chairman Bernanke has been vague, other than to say that a gradual but steady improvement in the labour market. Using the Fed's September economic projections as a guide to the required level of improvement in the labour market to prompt the Fed to start to tighten policy, suggests that the unemployment rate would need to have got to or below the 7% mark, assuming the inflationary environment is not an issue before than. In the latest Fed unemployment projections, this is not expected to happen until the end of 2014. In fact Bernanke was keen to stress in the press conference following the September FOMC meeting that the Fed 'wont be premature in removing policy accommodation'.

As regards further policy steps from the Fed, the hurdle is low for further action. The Fed has strongly expressed its dissatisfaction with the pace of improvement in the labour market and Chairman Bernanke is determined to provide as much support as possible

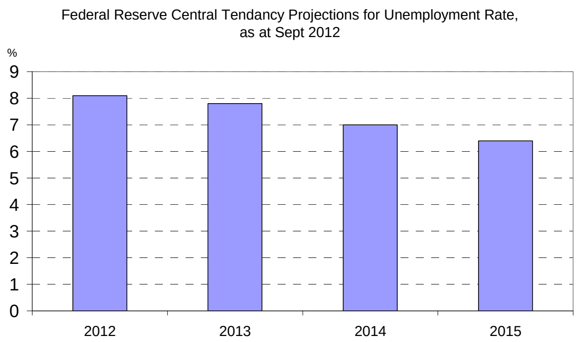
The concerns over the still 'high' unemployment rate, have prompted the Fed to do more to help the economy …

and on this basis we think more Fed action is likely. The current inflationary environment, where wage inflation remains stable and relatively low, provides the Fed with some comfort on the inflation front and inflation expectations remain stable and contained, thereby allowing the Fed the scope and flexibility for further monetary policy easing.



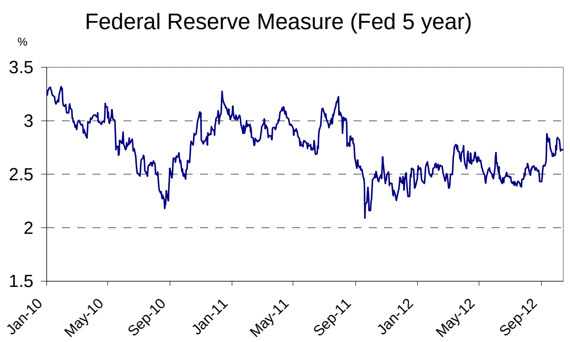
The form of further policy action is likely to be a further extension of the current asset purchase programme once the Fed completes its Operation Twist in December. The idea is that such action would maintain the current monthly run rate of long-term asset purchases at around $85bn, rather than allow it drop to considerably lower than that which it would in the absence of a decision otherwise. Outside of that, and if the required level of improvement does not start to materialise in the labour market, Bernanke stated that the Fed could expand it asset purchases further or employ 'a number of possibilities' including their communication policies and finding 'better ways to explain' their rate policies that will engender more accommodative financial conditions.

Latest Fed projections do not envisage the unemployment rate falling towards the 7% mark till end of 2014…



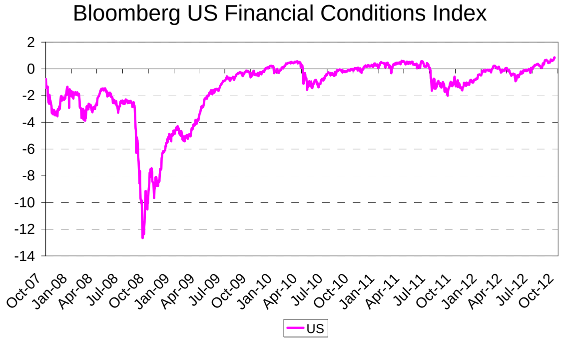
Bigger picture, while the Fed's aggressive actions will help to provide some much needed stimulus to the US economy, the issue of the 'Fiscal Cliff' (i.e. expiration of tax cuts and automatic spending cuts) and the uncertainty this is causing, encouraging businesses to hold off on hiring and expansion plans, means that a steady and more robust improvement in the US labour market may still be some way off. While the 'uncertainty' effect from the fiscal cliff is impacting this year, the direct impacts of the fiscal contraction would hit the economy in 2013. Based on the Congressional Budget Office (CBO) estimates, the total potential contraction if the full fiscal contraction was to come to pass would amount to 5% of GDP in 2013. However, the consensus in economic and political spheres is that the full fiscal cliff is likely to be avoided, with bipartisan agreement on some of the current fiscal stimulus measures being extended once the distraction of the presidential elections are out of the way. Notwithstanding agreement on some of the measures, there is still likely to be fiscal drag amounting to around 1- 2% of GDP next year. On the external side of the economy, there are potential risks from the ongoing debt crisis in Europe, as well as increasing signs of an economic slowdown emanating from Emerging Market economies which will hit the export side of the US economy.

…inflation expectations remain contained, allowing the Fed scope for further policy action …



On the plus side, household, business and banking sector balance sheets have undergone a comprehensive deleveraging process over the last 3½ years, leaving their respective balance sheet fundamentals in a much healthier state. The housing market is displaying some much wanted firmness, while credit conditions are becoming increasingly more supportive of economic activity.

…Financial market conditions are no longer a headwind and are now at the margin a tailwind for the economy…



Financial market conditions have now gone from being a headwind, to at the margin being a tailwind for the economy. At the same time, the Fed has committed to provide sufficient monetary stimulus to the economy in order to foster a more robust pace of economic growth and that it will not be too hasty in reversing this stimulus once a stronger recovery takes hold. On balance then, the US economy should avoid the scenario of a double dip recession, with the economy expected to grow in the region of 2 – 2.5% this year and a similar 2-2.5% range of growth is envisaged for next year, assuming a mild form of fiscal drag (1-2% drag on GDP) on the US economy in 2013. Growth of this magnitude in historic terms is disappointing, but still not a bad outcome, given the expected fiscal drag in 2013. Absent of this drag, the underlying trajectory of recovery is still encouraging, with overall private sector GDP in line to grow by 3-4%, which represents a reasonable pace of growth.

As ever, there are downside and upside risks to our base case forecast. The potential for fiscal mismanagement would be a key source of a negative surprise, as well as slower than expected growth in the global economy. But nonetheless some positive risks exist, including the housing recovery and the related beneficial knock on impacts, with the potential to provide further upside to the economy's growth trajectory.

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The Euro Area Economy and ECB Outlook

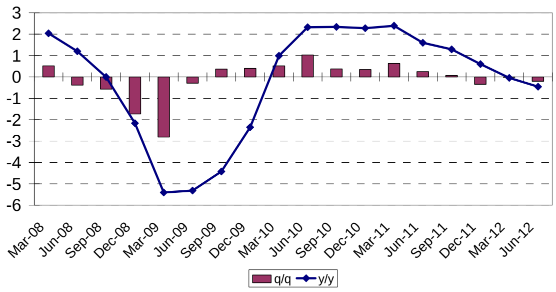
The euro zone economy continues to perform very poorly, with the most recent GDP figures showing real GDP running 0.4% lower than year ago levels. This reflects a sequence of very weak quarterly outcomes which have seen a stagnant first quarter straddled by a 0.3% q/q contraction in Q4 of last year and most recently a 0.2% contraction in the second quarter of this year. The expenditure breakdown of the figures reveals that the economy's poor performance owes much to a protracted period of contraction in domestic demand which has worked to outweigh positive contributions to growth from net trade.

Total domestic demand has fallen in each of the past four quarters, and is down 2.2% in y/y terms on the latest figures for Q2. Given the ongoing fiscal consolidation across the zone, it is no surprise that government spending is not providing any positive impetus to GDP growth. But the main source of domestic demand weakness has been declining investment. Capital formation has dropped for the past five quarters in a row, and was down 3.6% in y/y terms in

Q2. Investment trends in the euro zone have been held back by a host of factors. Most notably, economic agents have faced a huge amount of uncertainty, not only about future demand within and outside the euro area in the context of a very lacklustre global recovery, but also uncertainty about the very survival of the euro area in the face of crisis policy-making by European leaders that has consistently been substandard in both its formulation and implementation. Combined with the lagged effects of the major deterioration in financial conditions which occurred in the second half of last year and associated strains in credit conditions in parts of the zone, along with a distinct lack of animal spirits across the private sector, the result has been an exceptionally weak trajectory for euro area investment.

Euro area growth has been weaker than expected, with real GDP falling in two of the past three quarters…

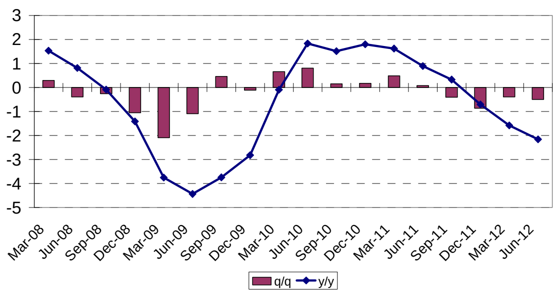
Euro Area Real GDP Growth, %



Corporate hiring too has been held back by similar forces. Quarterly employment growth has been negative for most of the past year, and employment levels are down 0.6% y/y. This has served to exert renewed upward pressure on the unemployment rate which has reached a new all-time high of 11.4% in recent months (records go back to 1990), with the trend higher a marked contrast to the mild improvement seen in both the US and UK. Such a poor labour market backdrop is obviously a negative for the household sector, and consumer spending has indeed fallen in four of the past five quarters to stand 0.9% lower than year-ago levels. Elevated inflation readings have also been a factor here, with inflation set to average around 2.5% in 2012 thereby eating into available spending power for an already-cautious consumer.

… the weakness has been concentrated in domestic demand which has been contracting for over a year now…

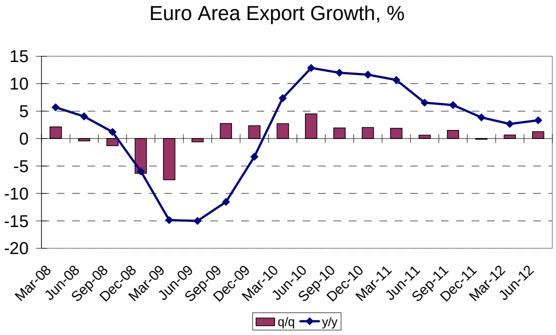
Euro Area Domestic Demand Growth, %



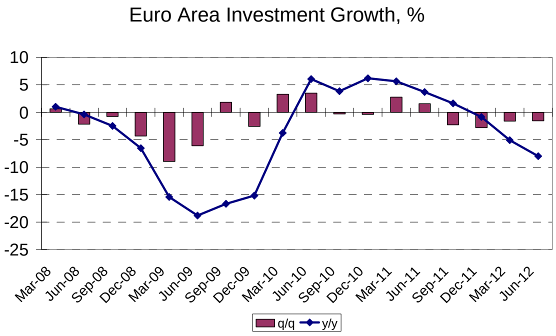
Exports have continued to provide a badly-needed offset to this weakness in domestic demand, but even here the trends have deteriorated. Annual export growth has remained positive, but at around 3% over the first half of this year, is markedly lower than the double-digit growth rates on show as recently as early 2011 reflecting a slower pace of global growth which has taken hold over the course of this year.

Of course, looking at pan-euro area aggregates such as these only tells part of the story as the currency union continues to be characterised by large-scale divergences in performance. Unemployment rates as at Q2 vary from levels in excess of 20% in Greece and Spain (23.1% and 24.6% respectively) to sub 7% in Austria, Netherlands and Germany (4.3%, 6.2% and 6.8% respectively). Annual GDP growth rates in the second quarter range from mildly positive in the case of countries including Germany, Austria and France to sharply negative in Greece, Portugal and Italy where growth stands at -6.3%, -3.3% and -2.6% respectively. Aside from the economic and social distress associated with such readings in the poor-performing countries, such divergences cannot be helpful from the point of view of promoting the required harmony, solidarity and common sense of

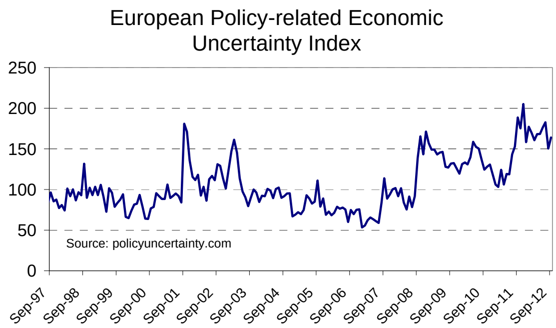
…exports have continued to provide a badly-needed source of growth, though trends have softened of late…



…while investment trends have remained especially weak, reflecting concerns about future demand…



…and very high levels of uncertainty…



urgent purpose among policy makers across as they seek to agree a policy agenda to address the multi-faceted nature of the current crisis.

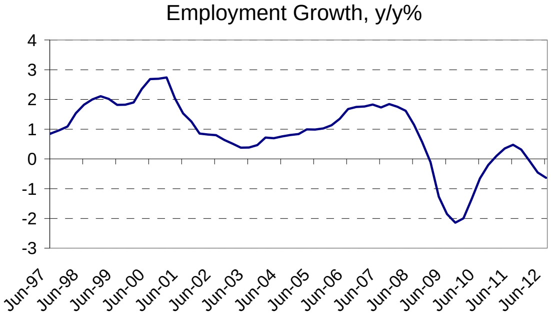
But recent months have seen a clear loss of momentum in some of the better-performing countries, including Germany where annual GDP growth has eased for the past five quarters to a sub-trend 1% in Q2 from as high as 4.9% as recently as Q1 2011. Moreover, more timely survey indicators suggest that growth in the zone's largest economy has continued to ease of late, with the October Ifo business confidence index falling to levels last seen in early 2010, for example.

With less support from a weakening Germany, trends in business confidence and activity for the zone as a whole have also remained very poor. Notably, the composite PMI – a usually-reliable business cycle indicator which tends to be well-correlated with quarterly GDP growth – fell to a new low for the post-crisis period of 45.8 on its latest reading for October. Not only is this level well below the expansion threshold of 50, but on past relationships points to a run rate for quarterly GDP of around -0.5% early in Q4. While there has been a tendency of late for the hard data e.g. industrial production to come in a bit better than signalled by the surveys such as the PMIs, we nevertheless take these latest results as an indication that the euro zone economy is set to remain in contraction mode through the final quarter. Q3 GDP figures are due later this month, and are expected to show a second consecutive quarterly decline, of around 0.2%, and we are pencilling in something similar for the final quarter.

That would leave the full-year 2012 outturn at -0.5% in annual average terms, which is a touch weaker than the ECB's latest (September) staff forecast the mid-point of which was -0.4%. Our forecast does allow for a less negative outlook for 2013. Global trends, including in the US, UK and Asia should be showing some mild improvement over the course of next year, helped by policy easing measures by many foreign central banks, particularly the Fed, which should support euro area export prospects. Indeed, the actions of the ECB itself have played an important role in producing a much more stable macro-financial situation in Europe, in the process helping global growth prospects by reducing concern about adverse tail risk outcome for the euro area.

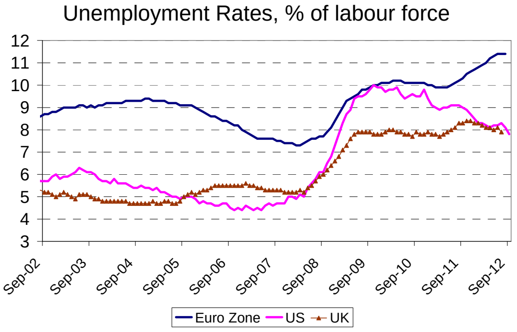
In our view, the past year has seen a more pro-active, assertive ECB emerge under the stewardship of Mario Draghi. In his twelve months in charge, the ECB has implemented three rate cuts and two 3-year LTROs, while most recently it has unveiled the Bank's Outright Monetary Transcations (OMT) programme. This latter initiative has particular significance as it provides a badly-needed backstop for euro area sovereign debt markets. Crucially, for the first time, the ECB is explicitly offering to engage in large-scale purchases of bonds in order to address the "severe distortions in government bond markets". The rationale for OMTs was clearly set out in the August post-meeting press conference in which Draghi outlined that the council were seeking ways to "address the severe malfunctioning in the price formation process in the bond markets of euro area countries. Exceptionally high risk premia are observed in government bond prices in several countries and financial fragmentation hinders the effective working of monetary policy. Risk premia that are related to fears of the reversibility of the euro are unacceptable, and they need to be addressed in a fundamental manner."

…employment trends have also deteriorated…



Draghi has also outlined clearly that activation of the OMT programme would only happen in the context of the country in question signing up for a programme of conditionality as part of an aid application to the EFSF/ESM bailout funds. So the market has yet to see the colour of the ECB's money as it were, as no country has yet formally applied for such assistance. Spain is the most likely country to be the first to apply, though its political leadership continues to resist in the hope it can muddle through. Few analysts, including ourselves, think Spain will be able to attract sufficient private sector financing to fund itself independently into next year, and so for us the question is how and when Spain gets to the point of applying. As has often been the case in European policy making, it may well again be a bout of intense deterioration in financial market conditions and resulting higher borrowing costs for Spain that act as the forcing mechanism for policy-makers to face the reality of what looks like an inevitable scenario.

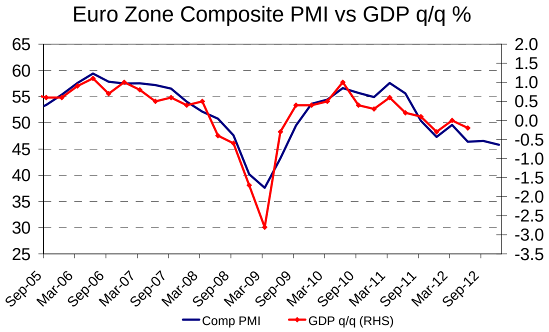
…pushing the unemployment rate to new crisis highs (in contrast to the declines seen elsewhere)…



Nevertheless, there has been a powerful announcement effect associated with the OMT, with bond yields and spreads across the zone well down on their summer peaks, in turn helping to promote a broader improvement in financial conditions in the euro zone and beyond. In fact, overall financial conditions in euroland have shown marked improvement since Draghi took over at the ECB. On one such metric compiled by Bloomberg (which looks at developments in bond, stock and money markets) the index has reached levels which are broadly neutral for economic growth, from a situation where a growth-sapping sharp tightening had been a consistent feature of the landscape. Indeed, that particular index is back to levels last seen prior to the outbreak of the crisis in 2007, consistent with genuine progress having been made in addressing some key crisis pressure points.

However, it would be wrong to be complacent on this front. Ultimately the ECB's policy initiatives, including the OMT, should mainly be seen as crisis-management type policy tools which serve to buy valuable time for countries and governments to get on with required substantive reforms in key areas. In particular, resolving the crisis more broadly will require further progress on 'completing the union'. In its present unsustainable form, European Economic and Monetary Union (EMU), has an unstable combination of a monetary union without true economic union. The ECB is charged with the management of the former, and its recent actions under Draghi underline its determination to do all it can to ensure the integrity of the monetary union. However, more progress will need to be made towards banking and fiscal union in order to round off the project.

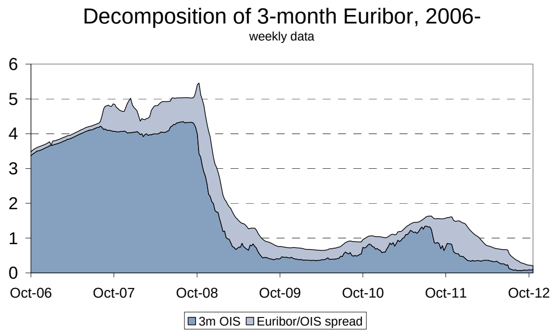
…more timely business cycle indicators indicate growth momentum remains very poor early in Q4…



Recent developments offer both encouragement and reasons for caution. Important agreements were reached at the June and October EU leaders summits which pave the way for the creation of a banking union and the possibility to finally break the negative feedback loops operating between sovereign and bank funding markets. However, a key first step is the establishment of a single supervisor mechanism, while moves are also required in relation to a zone-wide deposit guarantee insurance scheme and an agreed framework on bank resolution. Progress on implementation in these areas has lacked urgency as it again appears that political leaders struggle to take timely policy decisions in the absence of the pressure of highly strained market conditions.

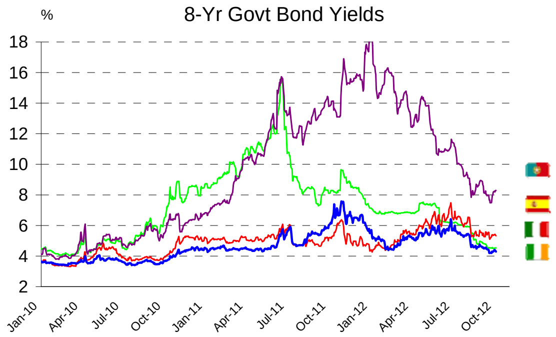
More generally, many countries across the zone will need to continue to engage in structural reforms and to consolidate their fiscal positions in order to improve their medium-term growth potential, improve competitiveness and reduce current account and fiscal imbalances. Yet structural reforms and fiscal consolidation, by their nature, require very difficult policy measures for politicians and their electorates, as is for example only too evident in Greece where social cohesion remains very fragile.

…but the Draghi ECB has been working hard to counter the headwinds, and has succeeded in getting money market rates down to all-time lows…



At time of writing, it looks as if its creditors will cut Greece some slack in the implementation of its adjustment programme, in keeping with a seemingly much more supportive stance now being taken by some key players, including Chancellor Merkel. A two-year extension on its fiscal programme now looks likely. However, even with such concessions, implementation risks around the Greek reform effort are going to remain very high. Given what is still an extremely difficult economic outlook in Greece (GDP is expected to fall by a further 4% next year after a projected 6% drop in 2012 on the IMF's latest forecasts), we think there is scope for Greek political and social tensions to resurface in the early months of next year linked to difficulties in hitting the required programme targets. Such a scenario would likely lead to another bout of tensions in financial markets both within and beyond the euro area as concerns surrounding the possibility of a 'Grexit' re-emerge. We continue to think that Greece will remain in the euro area as there is very strong mutual self-interest both for Greece and its fellow member states to avoid the enormous disruption and dislocation that would follow from any such departure. Our base case anticipates that as long Greek government remains committed to its reform programme, even if it continues to struggle to meet its quarterly fiscal targets, there will likely be further solidarity on offer. This could come via further extensions of fiscal targets, fresh loan assistance and possibly some form of Official Sector Involvement (OSI) at some point, where Eurozone countries eventually accept a write-down on their Greek loans.

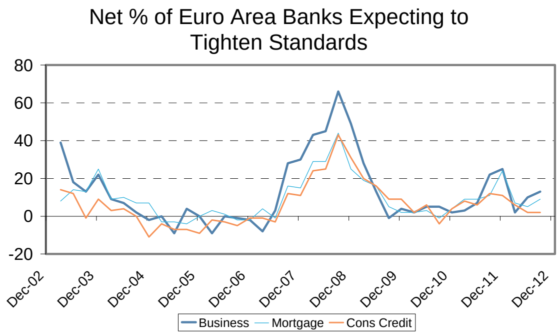
…and in lowering bond yields in vulnerable countries as its OMT initiative offers a "fully effective" backstop for sovereign debt markets…



And beyond the Greek issue, we do expect European leaders to stay on the path of progress in the right direction along the path of deeper economic, fiscal and financial integration. So our base case does anticipate some further lifting of uncertainty around the future of EMU over the course of next year and beyond, in turn aiding a return to positive economic growth in 2013.

However, policy formulation and implementation risks both in relation to Greece and to the wider integration project are meaningful. The track record of European leaders heretofore suggests that progress is set to be very gradual as acceptance of the required political compromises takes time to bed in in both stronger core countries (who face demands for higher levels of financial backing to underpin the system) and those in the periphery and quasi core (who face greater oversight and some loss of sovereignty in return for the greater financial support of the core).

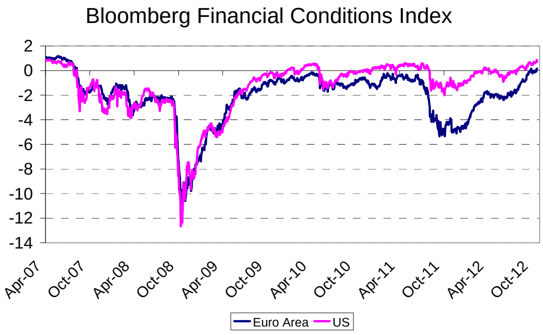
…while there has also been some easing in the degree of tightening in credit conditions …



Our base case anticipates some slight improvement in growth performance in 2013 when we expect a return to barely positive quarterly growth rates in the first half of next year, and a subsequent further gentle acceleration over the second half. Factors supporting such an outlook include the prospect of slightly better activity trends globally, less of a drag from financial conditions, and lower inflation which should support household incomes and spending. In average annual terms we expect GDP to show a return to slightly positive growth of around 0.2%, from the -0.5% we expect for this year.

In contrast, the ECB staff's September forecast is projecting growth of some 0.5% for next year. With the economy's run-rate likely to disappoint such expectations in the months ahead, and with the risk skew remaining very much to the downside, we think there is a clear case for the ECB to ease its overall monetary policy stance further, and we pencil in a further cut in ECB rates by the end of Q1. Such a move would take the main refinancing rate down to a new record low of 0.5%, and the deposit rate to below zero (as has recently been done in Denmark). Admittedly, our conviction around this call is not particularly high, as the ECB's focus for now appears to be very much on trying to improving the functioning of the transmission mechanism for its existing policy stance across the zone via the OMT programme. Plus, the October policy statement

…notably, overall financial conditions, for the first time in five years, are no longer acting as a headwind to growth. It is crucial that politicians build on this central bank-led improvement and make rapid progress on completing EMU. We remain cautious on policy formulation and implementations risks

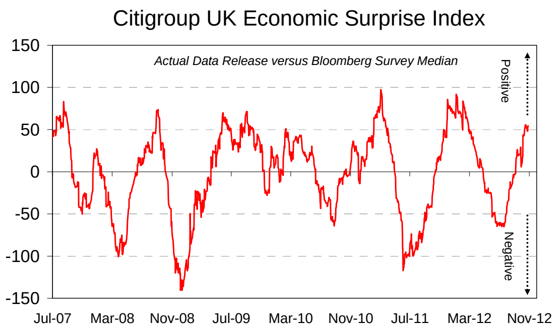


hinted at a slight note of caution on recent higher than expected inflation readings. Nevertheless, it seems clear to us that the ECB retains an easing bias and that if there is to be any further change in its policy stance (whether that be a further lowering of rates, or a further easing of its collateral rules, or additional liquidity support) over the forecast horizon (to the end of 2013) it is almost certainly going to be an easing rather than any tightening.

In any case, with ECB policy under Draghi already extremely accommodative and stretching the limits of what can reasonably be expected from a central bank, the euro area outlook hinges to a larger degree on policy choices and outcomes within the realm of political leaders. Arguably, the strongest contribution to growth which economic policy making can make at present would be for senior political figures to show strong decisive leadership and rapidly advance and implement their plans for deeper integration. Swift concrete progress would serve to underpin policy initiatives implemented to date and therefore boost policy credibility, reduce related uncertainty about the survival of EMU, and bolster confidence among economic agents within and outside the euro zone. However, on recent past performance it would be imprudent to count on anything beyond gradualism from Europe's leaders. Indeed, the danger is of slow and inadequate progress, which means that the euro zone macro-financial outlook continues to face material downside risks as we head into 2013.

The UK Economy and MPC Outlook

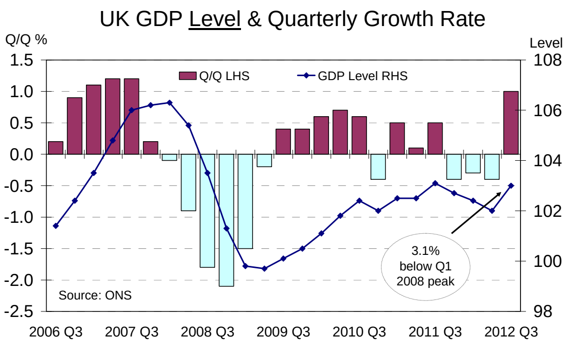
UK economic data has largely surprised to the upside since September…



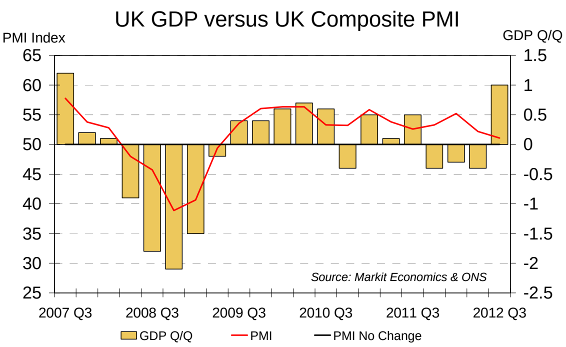
While the latest GDP figures signalled an official end of the longest double-dip recession since the Second World War, the underlying economic conditions remain challenging. Nevertheless, following a steady stream of disappointing UK economic newsflow during the summer months the tide, at least for the time being, appears to have turned. Since September the incoming UK data has been much better than analysts expected, as highlighted in the Citigroup UK Economic Surprise Index. In October, alongside the better than expected Q3 GDP figures the improved tone of the news flow has included: retail sales, the labour market and even the public finances. The resumption of economic growth is essential for the UK's deficit reduction plan. However, it is the rate of growth and whether expansion can be maintained in Q4 and beyond that is important.

The economic recovery anticipated by policy-makers has not taken hold. No growth, or indeed even sluggish growth, makes the

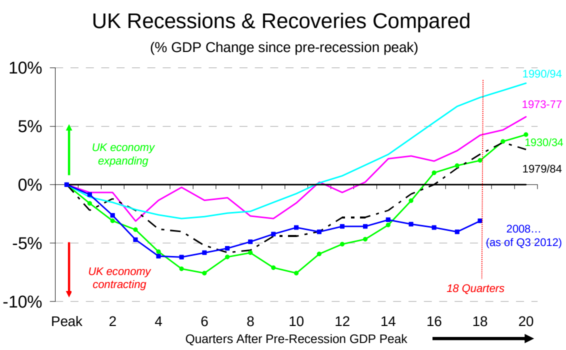
…with Q3 GDP posting its strongest quarterly gain in 5 years with a 1% q/q expansion…



…but other surveys – PMIs - suggests the UK underlying economic growth remains weak…



… UK experiencing an even weaker recovery than the 1930s…

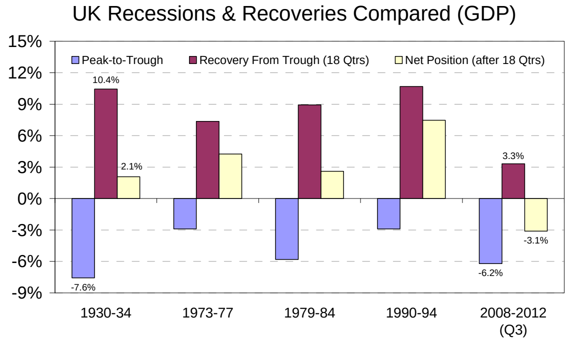


coalition government's deficit reduction programme much more challenging. Back in March, the Chancellor's Budget 2012 projections forecast economic growth of 0.8% this year followed by 2% in 2013. However, the first half of 2012 has already proved to be much weaker than expected with these earlier forecasts proving to be overly optimistic. Indeed, the level of growth in Q3 & Q4 will be probably only sufficient to avoid an outright contraction in 2012 for the year as a whole. In turn, this weaker growth has led to lower than projected tax receipts which have necessitated higher levels of government borrowing. This will require further fiscal adjustments when the Chancellor delivers his Autumn Statement on 5th December 2012. Meanwhile the external environment has also deteriorated in recent months and this will limit the pace of the UK recovery next year, particularly through trade. Ultimately, the most important driver for the economic recovery will be the health of the UK consumer. In turn, this will be strongly influenced by the inflationary outlook.

Within media circles, the headlines concerning economic growth are fixated with whether GDP growth is positive or negative. However, both the Q2 & Q3 GDP headlines exaggerate the contraction and rebound respectively. The bulk of the Q2 quarterly decline can be explained by the lost output resulting from the additional Diamond Jubilee Bank Holiday in June. According to the UK National Institute of Economic & Social Research (NIESR), if this effect was stripped out marginal growth would have been recorded. Similarly, the *'robust growth'* in Q3 GDP, of 1% q/q, exaggerates the underlying strength of the economy. The apparent 'V-shaped' recovery is linked to two factors. First, the reversal of the negative effect from the additional bank holiday in June artificially boosted Q3 output. Second, the allocation of Olympics ticket sales purchased last year appears in Q3 GDP. Stripping out these two factors suggests underlying growth is closer to 0.4% which is what other surveys, notably the PMIs, have signalled. This remains about half the average quarterly rate of growth prior to the recession. Of more significance will be whether the momentum can be maintained in Q4 2012 and Q1 2013. If, as we expect, the UK ekes out GDP growth of 0.2% q/q or higher in Q4 it will avoid an outright contraction for 2012 as a whole. However an annual growth rate of 0% for 2012 is hardly inspiring. Thereafter, given the significant domestic and international headwinds facing the UK economy, the quarterly growth rate in 2013 is expected to be around 0.3%. Looking at 2013 as a whole we forecast a growth rate of 1.2%, which compares with the Chancellor's projection of 2% in March.

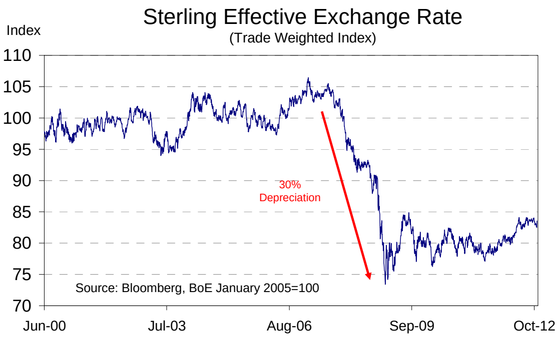
It is also important to put the UK's recovery in a historical context. The strength of the economic recovery has taken economists and policy-makers by surprise. Furthermore, it is noted that the UK's

… after 18 quarters the UK economy is still over 3% smaller than it was in Q1 2008



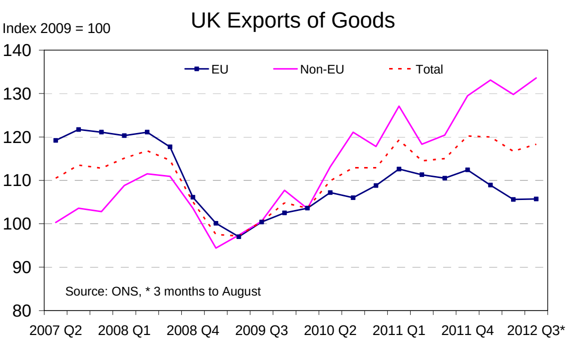
economic recovery has been even weaker than the rebound following the Great Depression during the 1930s. Some 18 quarters have passed since the UK's pre-recession GDP peak of Q1 2008 and only half of the output lost during the downturn has been recouped to date. This represents a weaker economic recovery than occurred during the Great Depression *(1930-1934)*. Back then, the UK economy experienced a peak-to-trough recession of 7.6% which was deeper than the 6.2% decline in 2008/09. However, by Q1 1934, some 16 quarters after the pre-recession peak *(Q1 1930)*, all of the lost output had been recovered. After 18 quarters, the UK economy was 2.1% larger than it was before the Great Depression began. Similarly, four years *(16 quarters)* after the pre-recession peak *(Q2 1979)* of the early 1980s recession, all of the lost output had been recouped. Now, however, 18 quarters have elapsed since the pre-recession peak in the latest downturn and the UK economy is still 3.1% smaller than it was in Q1 2008. Indeed, it is likely that it will be 2014 before UK output returns to its 2008 peak. This represents a lengthy 6-year economic recovery.

Sterling's depreciation has aided price competitiveness for exporters, however lack of demand is an issue…



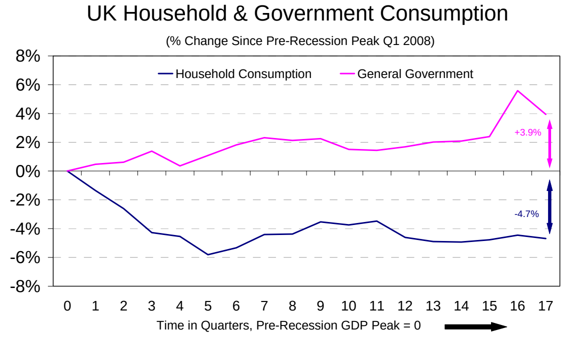
…particularly within EU markets although the level of good exports are higher now than pre-recession …

Like economies elsewhere, the UK is competing in a challenging external environment which is not conducive to an export-led recovery. Total UK exports have increased significantly since sterling's depreciation in 2008/09. Indeed, total exports are now higher than when they were at the pre-recession peak. However, some markets have performed better than others. Exports of goods to Non-EU markets *(excluding oil and erratic items)* have increased by 42% relative to the Q1 2009 trough and are now 20% above the pre-recession peak. Meanwhile export markets closer to home have fared less well as the recession in a number of euro zone economies deepens. Exports of goods to the EU, which account for over half of all UK exports, have already fallen by 6% since Q4 2011. Furthermore, despite sterling's depreciation relative to the euro, UK exports to the EU are just 9% above the trough recorded in Q2 2009. Lack of demand in the UK's largest export market remains a cause for concern in forthcoming quarters. As a result, export growth will not provide as strong a tailwind to economic growth that had been expected earlier in the year.

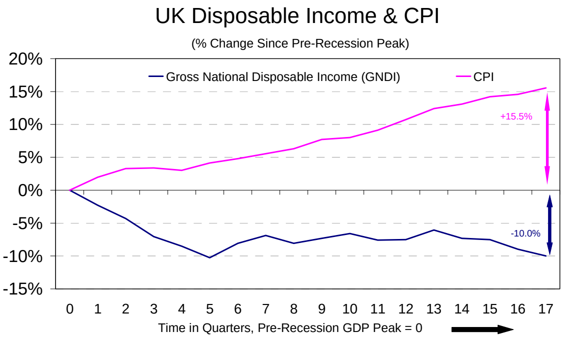


The ongoing uncertainty surrounding the euro zone crisis will also dampen investment intentions over the next 12 months with UK corporates reluctant to part with their cash piles. Nevertheless, business investment should still contribute positively to growth next year. By comparison, government consumption *(public spending)* will act as the largest drag on economic growth in 2013. This follows its role in 2012 as being the primary contributor to economic growth. It should be remembered that public spending is still rising with the automatic fiscal stabilisers *(e.g. unemployment benefit)* rising to meet demand.

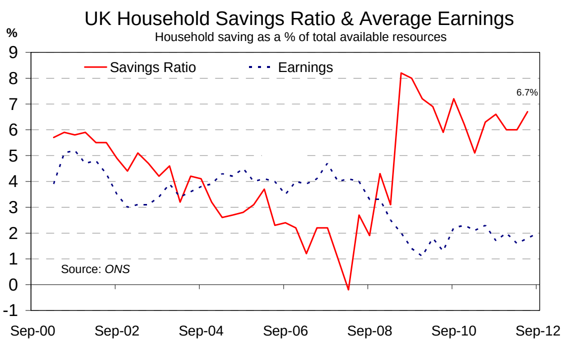
…government consumption is at a higher level now than pre-recession but household consumption is much lower…



…inflation has meant UK gross disposable incomes are 10% lower relative to Q1 2008 …



…rise in savings ratio coupled with fall in real earnings have crimped consumer spending…

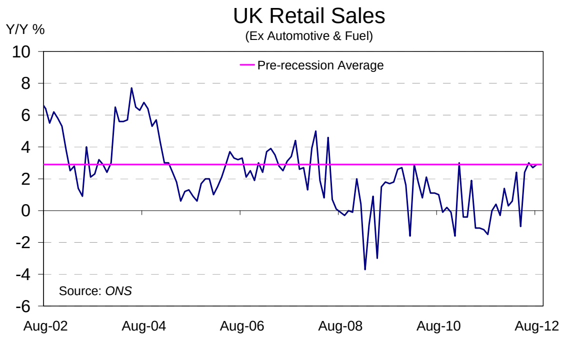


Ultimately, the economic recovery will be dependent upon consumer spending, which accounts for 60% of GDP. While the level of government consumption and exports are well above their pre-recession levels the same cannot be said for household consumption. This is the biggest single factor explaining the UK's poor economic recovery. UK household expenditure increased cumulatively by 43% in the decade prior to its Q4 2007 peak, which preceded the overall GDP peak by one quarter. This represented an average growth rate of 3.4% which was more than twice the average annual rate of CPI inflation *(1.6%)*. Rising incomes alongside a plentiful supply of credit were the drivers for this increase in household expenditure. It is noted that the stock of household credit has been growing at less than 1% p.a. over the last two years, which compares with an average of 10% in the years leading up to the recession. Following a 6.6% peak to trough fall in household expenditure in the 6 quarters to Q2 2009, the UK has witnessed an increase of just 1.2% in three years. As a result, household expenditure remains 5.5% below its pre-recession peak.

Falling consumption is not a surprise given the combination of rising inflation, falling national disposable income and the need for households to deleverage. Since the UK's pre-recession peak of Q1 2008, consumer price inflation has risen cumulatively by 15.5% up to Q2 2012. Meanwhile disposable incomes have fallen by 10% over the same period. In addition, rising unemployment and job insecurity have encouraged households to save a higher proportion of their falling disposable incomes. The UK's savings ratio *(6.6%)* is now back to a level similar to that in the early 2000s. Against this backdrop consumer sensitive sectors have suffered greatly. Indeed, the UK has witnessed the closure of almost 1,000 high street chain stores in the first half of 2012. More recently, however, there has been a pick-up in retail sales with the annual growth rate in retail sales *(excluding car sales and fuel)* back to the pre-recession average.

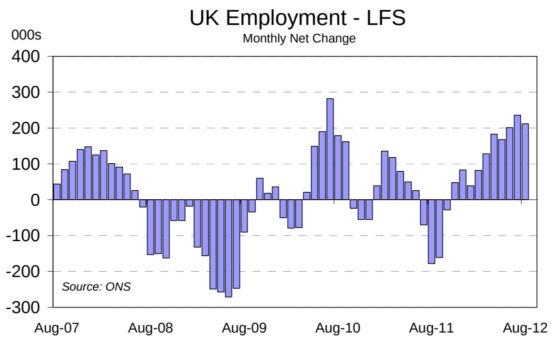
Two key factors behind this are the improvements within the labour market and a fall in the annual rate of inflation. Whilst output remains well below pre-recession levels the number of people in employment has never been higher. During the first eight months of 2012 the number of people in employment has increased by 1.25 million. UK employment is now at its highest level on record. However, this largely reflects a rise in part-time employment as opposed to full-time employment. The number of individuals in full-time employment in the three months to August 2012 was 2.6% below its peak in Q2 2008. Meanwhile part-time employment has increased by 8.3% over the same period. Alongside rising employment the unemployment rate has also moved lower from 8.4% in Q4 2011 to 7.9% in the three months to August. We expect a return to this earlier high of 8.4% in 2013 before a downward path resumes going into 2014. However, the main labour market challenge will be youth unemployment with 1 in 5 of those aged under-25 looking for work unable to find it. Overall, with employment levels continuing to rise, this will be supportive of a recovery in consumer spending provided the incomes squeeze comes to an end.

…but signs that consumer sentiment is improving in the High Street…



While the income squeeze may not have ended the pressure on household budgets is lessening. The annual rate of consumer price inflation has fallen from 5.2% in September last year to 2.2% in September. However, it has been the cumulative rise in consumer prices that matters particularly when these dwarf increases in income. Over the last 5 years CPI has risen by 18%. Meanwhile food prices and utility bills have increased by 30% and 50% respectively over the same period. As long as the rate of inflation keeps retreating throughout 2013 there should be a modest pick-up in household consumption. According to the Bank of England's latest Quarterly Inflation Report *(August 2012)* CPI is expected to fall below the MPC's 2% target in mid-2013 and stay below this level at the 2-year horizon. This was under the assumption of no more policy stimulus beyond the £375bn of asset purchases. This undershoot implies that the BoE is minded to apply more monetary stimulus, i.e. more quantitative easing or asset purchases. More recently, the MPC minutes for October highlight some short-term inflationary pressures in the shape of utility and agricultural commodity prices.

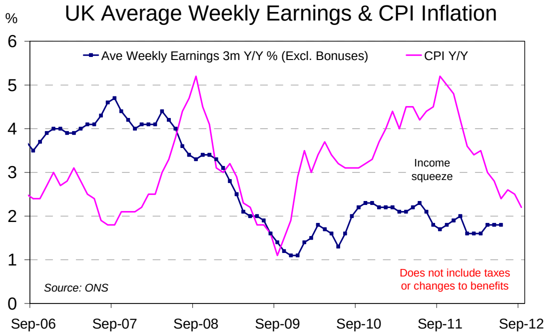
…with strong employment growth a feature of 2012…



Since the August Quarterly Inflation Report (QIR), the pace of UK economic growth has been slightly better than the BoE's MPC had anticipated. Meanwhile the latest MPC Minutes for October note that *'some members felt that there was still considerable scope for asset purchases to provide further stimulus. Other members…. questioned the impact that lower long-term yields on corporate debt and equity would have on the broader economy at this present juncture'.* To us, this doesn't appear to be an MPC lining up for another round of quantitative easing. Indeed, a recent speech by Sir Mervyn King on 23 October appears to suggest that the economy will have to weaken further before additional QE is triggered. '*The MPC will think long and hard before it decides whether or not to make further asset purchase. But should these signs fade, the MPC does stand ready to inject more money into the economy'.* In our base case we do not anticipate any further rounds of quantitative easing in the foreseeable future. For such a scenario to arise we would have to see a realisation of some of the downside risks to growth.

In the meantime the BoE will continue to keep its Bank Rate on hold at 0.5% for the foreseeable future and monitor the performance of its recently established new Funding for Lending Scheme (FLS). The latter provides banks with access to finance for up to four years

…further employment growth required & CPI must continue to fall for a consumer led recovery to truly take hold…



at below prevailing market rates for term funding. Crucially, the more banks lend to businesses and households the cheaper that funding will be. The BoE's latest inflation and economic growth projections will be unveiled on 14 November. These will be followed by the latest fiscal projections which will accompany the Chancellor's Autumn Statement on 5 December.

RR

FX Outlook

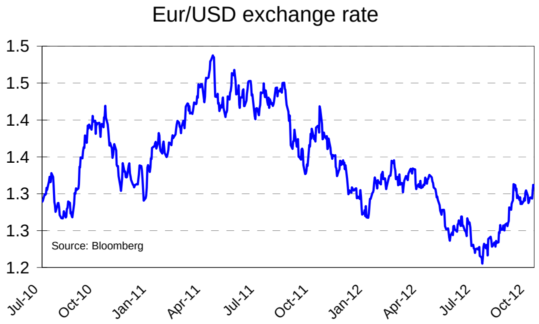
Eur/USD

The Eur/USD currency pair has traded in general terms within the $1.285 to $1.31 range in recent weeks and is broadly speaking at a similar level to where it was as the year got underway. However, in between this period (i.e. January to October), the currency pair has closed as low as $1.20 and had a closing high within touching distance of the $1.35 mark.

The first quarter performance saw Eur/USD experience some upward moves, trading in a range of $1.30-1.35 as upside surprises to euro zone macro data, positive market reaction to the ECB's expanded liquidity provisions (i.e. 3 year LTROs) and a general improvement in market risk appetite provided some upward momentum to the currency pair. As the second quarter progressed and as we had envisaged in our February Market Focus, the currency pair came under increasing downward pressure. The renewed concerns over the debt crisis in Europe, Greek elections followed by more Greek elections, Spanish sovereign debt markets coming under heightened pressure and the increasing realisation that the banking sector use of the LTRO's to buy sovereign debt further heightened the potentially burdensome link between the banking sector and the sovereign put downward pressure on Eur/USD. The ECB rate cut in July provided further downward momentum to the currency pair as we passed through the half year mark, and by mid July Eur/USD closed at its lowest level of the year of $1.20, which was in line with our forecasts for the mid point of the year.

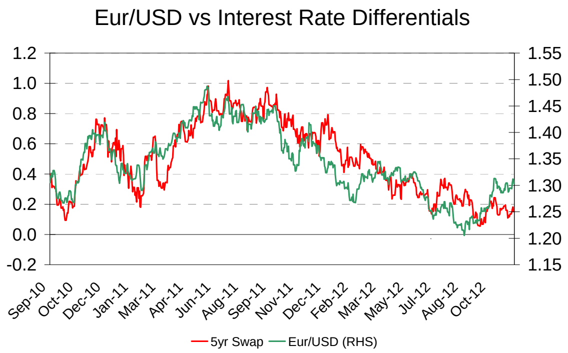
Since then, Eur/USD has recovered from this low and has been on a relatively steady upward trend, moving back up toward the $1.28 - $1.31 range. A key factor behind this move has been the announcement from the ECB of its new bond buying programme, known as OMT, which has helped to remove some of tail risks facing the euro from the periphery and specifically in relation to Spain. ECB President Draghi hinted at the plan at the August ECB meeting and backed up these comments with a concrete policy announcement at the September meeting. The ruling of the German Constitutional Court in mid September, which rejected objections to the ESM and the Fiscal Compact also removed another important short term tail risk facing the debt crisis. These developments helped to build on the positive sentiment towards the region following the July EU leaders summit, where agreement was reached in principle on direct recapitalisation of European banks, which would help to break the potentially toxic link between the sovereign and the banking sector. On the dollar side, the increasing expectation and then the actual announcement from the Fed in September in relation to QE3 has been a source of weakness from the dollar side of the currency pair. On the liquidity side, there has been some unwinding of the extreme short positions of Eur/USD in recent weeks, helping to support the currency pair. The movements of the currency pair year to date have broadly followed the path of our fair value Eur/USD model. This model is designed to guide on potential movements in the currency pair in the context of variables that we think are important determinants, including interest rate differentials, Spanish 5 year CDS (measure of periphery stress) and the S&P 500 (measure of risk appetite).

Eur/USD has been on a broadly upward trend since moving of its low of $1.20 in July and in recent weeks has moved back up above the $1.30 mark….



While the euro has rallied in recent days, a key factor for the near term outlook for the Eur/USD currency pair is the issue of Spain and the timing and manner in which it applies for financial assistance. For the ECB's new bond buying programme to become operational, a sovereign must first request external financial assistance before the ECB will commence bond purchases. Our base case is that the Spanish government will try and maintain its current stance of holding off requesting aid for as long as possible. Therefore it is likely to take increased market pressure, primarily in Spanish sovereign debt markets, resulting in higher borrowing costs that will force Spain into asking for assistance before the end of Q4. In the intervening period, the Spanish reluctance to apply for assistance would foster renewed risk aversion in financial markets. The uncertainty associated with a Spanish request for aid, as well as risk off market behaviour is likely to result in euro weakness, while the dollar may benefit from the increased level of risk aversion. These factors would bring downward pressure on Eur/USD and in such a scenario we see the potential for Eur/USD to fall towards the $1.25 level.

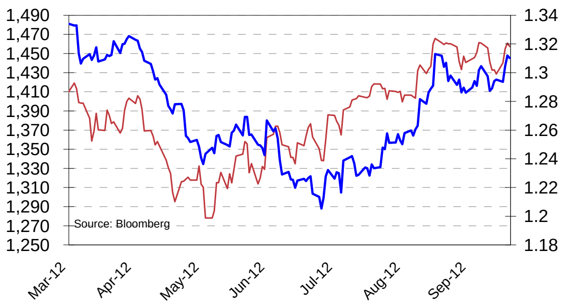
Movements in relative market interest rates were an important driver for most the year, however their impact has lessened in recent weeks …



By year end, if Spain has been forced into requesting assistance, in the context of a bout of market stress, the market is likely to view such a development favourably, as it triggers the ECB's new bond buying programme, which is designed to repair the monetary policy transmission mechanism. This in turn would improve market sentiment towards the euro and also help reduce a short term tail risks for Eur/USD and in turn provide some scope for a rally in the euro. On the dollar side, as we end into the year end, a further expansion of the Fed's balance sheet has the potential to provide some dollar weakness, although more action from the Fed on the QE front would not come as a huge surprise to FX markets. At the same time, the fiscal cliff concerns in the US as well as uncertainty over other forms of government policy, linked to the presidential elections are expected to come more into focus over the coming weeks. An expected bumpy road to getting agreement on fiscal policy between the Democrats and Republicans once the US elections are out of the way has the potential to support the dollar side of the currency pair from a risk aversion perspective. However, ultimately we believe that some progress will be made on the fiscal cliff issue as we near year end, removing some of the safe haven demand for the dollar. Weighing up these factors, we see the potential for the currency pair to trade in the $1.31-1.32 range as we head into year end.

…improving risk appetite has also been an important driver of Eur/USD throughout the year

Eur/USD & S&P 500



Looking towards the first half of next year, the lacklustre performance of the Euro zone economy and the likelihood that the economy will not show any material improvement, may result in a further easing of monetary policy from the ECB. On this basis the euro may come under renewed downward pressure in the early months of 2013. In addition to monetary policy factors, bigger picture issues in relation to the structure and governance of EMU, combined with uncertainty over the implementation of policy solutions to the debt crisis, difficulties in the fiscal consolidation process, ongoing concerns over Greece, increased deleveraging in the region, as well as political risks (general elections due in Italy) in the first half of 2013 all point to downside risks for the euro in this period. Even though the Fed will remain in a highly accommodative monetary policy stance, on balance, the bias for Eur/USD in the first half of 2013 is for some downside to the currency pair, with Eur/USD having the potential to fall back towards the $1.25 level.

The expected intensification of concerns over the Euro zone debt crisis in the first half of 2013 may result in policy makers being forced to assume a greater role in getting to grips with the debt crisis. Signs that politician's and key European institutions are making progress in dealing with the debt crisis, including gradual progress on the issue of a banking union is likely to reduce the level of uncertainty surrounding the region as we get into the second half of 2013, thereby providing some support for the euro. From a dollar perspective, an improvement in risk appetite in the second half of 2013 may be a headwind to the dollar, assuming risk appetite remains a key driver of the currency. On the macro front, we expect the US economy's underlying trajectory to pick up over the course of 2013, once early year fiscal tightening fades. In this scenario we would anticipate some greater focus on the economic improvement in the US, both in absolute and relative (to EZ) terms. The stronger relative economic performance of the US, may see interest rate differentials offering support to the dollar.

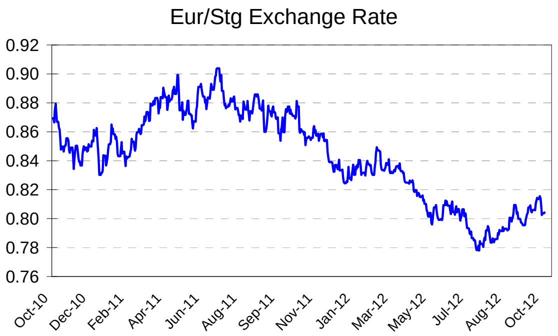
On the back of this, we see the currency pair ending 2013 around the $1.25 level as the strength from the euro side on the back of improvement in the debt crisis and the dollar strength arising from the improving economic trajectory of the US economy have a cancelling out effect on each other in the currency pair. While this is our base case, given the ongoing uncertainties in relation to the debt crisis in Europe and policy uncertainty in the US, there is scope for bouts of volatility within this context over the next 12 months.

JF

Eur/GBP

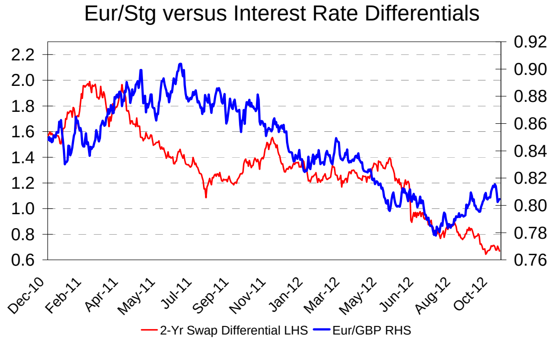
The broad direction of the Eur/GBP currency pair, as with Eur/USD, was downward during H1 2012. Having reached a high of 84.9p in late-February, interest rate differentials (5-year) acted as a driver behind the downward move in Eur/GBP in Q2. The summer months saw an intensification of concerns with the euro zone debt crisis and Spain in particular. Investors began to shun Spanish sovereign debt with the cost of 10-year government debt hitting a high of 7.6%. This represented a premium, or bond spread, of 638bps relative to the German 10-yr benchmark. At the same time the interest rate differential between 2-year euro and sterling swap rates continued to narrow and made holding euros relative to sterling less attractive. As a result of these factors, Eur/GBP hit a low of 77.7p on the 24 July 2012. Incidentally, this coincided with the record yield on 10-yr Spanish sovereign debt.

Over last six months Eur/GBP has been on a downward path on the back of the deterioration in the debt crisis & concerns over Spain…



Since Q3 tough rhetoric and concrete policy proposals *(e.g. OMT)* from the ECB President, Mario Draghi, has helped soothe concerns over Spain and the wider euro zone debt crisis. As a result, the single currency has regained a firmer footing and has been broadly trading within the range 80p – 81.5p. This rise in the Eur/GBP has also been driven by similar moves in the Eur/USD currency pair. The latter has been linked to a return of risk appetite and rising equities. However, recent economic data, particularly the better than expected Q3 GDP reading, alongside recent speeches from MPC members *(notably the Governor on 23 October)* have lowered expectations of more QE in November. In turn, the prospect of no more QE is sterling positive and has helped push Eur/GBP back towards the 80.6p mark.

Rate differentials remain important for Eur/GBP also…



Looking ahead, we expect Spain to avail of assistance in the coming weeks in order to activate the ECB's Outright Monetary Transactions (OMT) bond purchasing programme. In the short-term, such a bailout, by removing uncertainty, is deemed to be euro positive. Therefore we target 81p by the year end. It is noted that 81p is the current 200-day moving average and this level will offer resistance against a further move significantly higher. Going into 2013 the lacklustre performance of the euro zone economy is set to continue with the lack of improvement necessitating further ECB policy stimulus. On this front we anticipate a 25bps cut in the ECB refi rate. In light of this, and the anticipated tensions regarding moves towards a Banking Union and wider fiscal integration, the euro is likely to remain under pressure in H1 and back below 80p. We target 78p in Q1 and 79p in Q2. Thereafter, we anticipate the European policy-makers will have made better progress towards resolving the euro zone debt crisis and this should be reflected in improved sentiment towards the single currency in H2. We target 81p by 2013 year-end.

RR

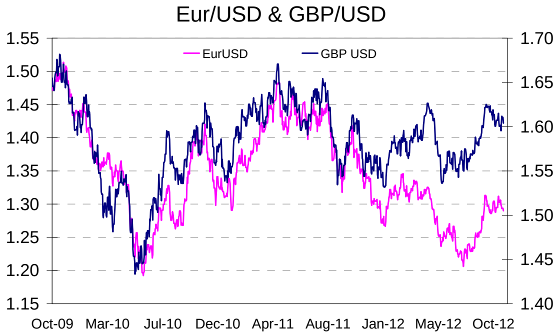
GBP/USD

Traditionally the dollar has a negative correlation with risk appetite. When equities rally the dollar weakens and vice versa. Therefore when concerns over the euro zone debt crisis intensify, leading to risk aversion, the dollar tends to benefit vis-à-vis the single currency. This is what occurred during the summer months as financial market concerns regarding the euro zone, and Spain in particular, intensified. As a result, EUR/USD traded below $1.21 when euro-zone *(& Spanish)* financial market stress peaked in July.

Throughout the euro zone debt crisis EUR/USD and GBP/USD have closely tracked one another. Given that the UK economy is so inextricably linked to the fortunes of its largest trading partner – the euro zone – this is hardly surprising. So when the single currency loses ground against the greenback this also feeds through into the GBP/USD currency pair. However, since the start of the year the positive correlation between GBP/USD and EUR/USD has changed. This has resulted from sterling's gains against the euro over the last 10 months as it benefited from safe-haven status relative to the euro zone. Indeed, in early August the UK's 10-Yr government bond spread relative to Germany narrowed to just

10bps. Nevertheless, the strong positive correlation remains but the two currency pairs have moved to new trading ranges.

…GBP/USD has largely followed the same pattern as Eur/USD but new trading ranges have emerged in 2012…



During 2012, cable has broadly been trading within the range $1.54 - $1.62. During the summer months the combination of weaker than expected UK economic data; risk aversion; and some contagion from the euro zone debt crisis, kept cable within the range $1.54 - $1.58 between June and August. Since then, a return of risk appetite, aided by policy announcements from both the ECB and the Federal Reserve in September, has pushed cable back up to a new range of $1.60 - $1.62. The recent high of $1.6250 followed the FOMC announcement on 13 September of open ended quantitative easing which weighed negatively on dollar sentiment. In the short-term, we target $1.63 by year-end on the assumption that the Bank of England does not initiate a further round of quantitative easing in November. At present, this is a reasonably close call and sterling is likely to benefit from a 'no change' policy decision from Threadneedle Street. Thereafter, our view, on a multi-quarter basis, is one of the dollar gaining strength primarily on the back of improvements within the US economy. As a result, for 2013 we target $1.58 by mid-year and $1.54 by year-end.

RR

EUR/JPY

The Eur/JPY currency pair has experienced strong appreciation since the start of the year, and is currently over 3% higher on a year to date basis. The trend of the currency pair has followed a similar path to that of Eur/USD this year. The first quarter performance saw the euro side of the currency pair benefit from improving sentiment towards the Euro zone and the general improvement in market risk appetite over this period. Given that the Yen is regarded as a safe haven currency, thereby tending to benefits from periods of risk aversion, the opposite is true, when risk appetite picks up. As a result, weakness from the Yen side of the currency pair, combined with euro strength, saw Eur/JPY close as high as Y111 in the first quarter. The second quarter performance of Eur/JPY was characterised by weakness, as renewed concerns over the Euro zone debt crisis acted as a downward force over the euro's performance, pushing the pair as low as Y95.6 by the halfway mark. The ECB rate cut in July added further downside momentum and the currency pair hit its year low of 94.2 in July.

Since then, the Eur/JPY pair has been on a steady upward trend, as the ECB's announcement of its new bond buying programme, designed to repair the monetary policy transmission mechanism provided some positive support to the euro. On the yen side, the combination of the improvement in the risk appetite environment and the Bank of Japan increasing its asset purchase programme by Y10 trillion to Y80 trillion contributed to some yen weakness. These factors helped push the Eur/Yen rate back up through the Y100 mark. In recent weeks, the euro rally has resulted in further upward momentum to the currency pair, pushing it towards the Y103.

Eur/JPY has moved higher year-to-date…

Eur /JPY exchange rate

The near term outlook holds the possibility of some reversal of the recent rally if the Spanish aid request uncertainties lead to renewed market stress and with it the potential for Eur/JPY to drop towards the Y100 mark. However, an expected triggering of the ECB's new bond buying programme before year end should be euro positive. On the yen side, if the yen continues to strengthen, the exporting backdrop for Japanese companies becomes even more challenging, leading to renewed speculation and the possibility of further QE from the Bank of Japan. Given these factors, we see the potential for the currency pair to trade in the Y102-103 range as the year comes to a close.

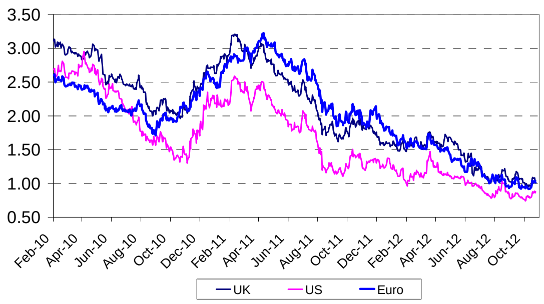
Looking ahead to next year, the potential for Euro zone debt crisis issues to escalate in the first half of the year would be a negative for the euro. General market stress arising out of renewed concerns over the debt crisis could act as a support to the yen, assuming risk appetite remains a driver of the currency. In such a scenario, Eur/JPY has the potential to fall below the Y100 level. However, the weak economic fundamentals of the Japanese economy, combined with some euro strength on the back of anticipated progress by EU policymakers to deal with the debt crisis, provides scope for Eur/JPY to move higher after some early year weakness. Therefore we target the pair moving back up towards the Y101-102 range by year end.

JF

Long-term Rates Outlook

Swap rates have continued to trend lower this year, with 5-year rates hitting fresh record lows across the board in recent weeks …

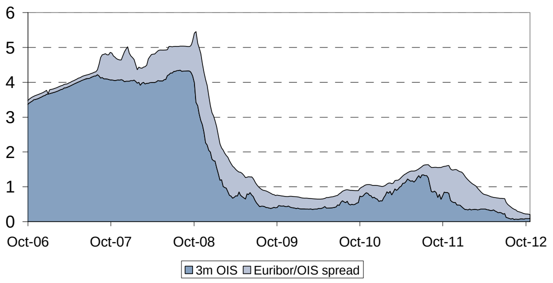
5-yr Swap Rates, Feb '10 -



…a move led by lower short-dated rates, notably in euros…

Decomposition of 3-month Euribor, 2006-

weekly data



In our previous update, we highlighted the potential for further declines in long-term rates, and our forecast envisaged the establishment of fresh all-time record lows in 5-year rates across euro, sterling and dollar markets. In the event, 5-year rates have fallen by even more than we had anticipated, with 5-year dollar rates reaching as remarkably low as 0.75% earlier this month, while the euro and sterling equivalents have also reached never-before-seen levels of sub 1% in recent weeks.

As we regularly observe in this context, monetary policy and expectations thereof play a key role in driving trends in long-term rate markets and this has once again been the case in recent months. This has especially been the case in Europe, where the Draghi ECB has adopted a more pro-active role than under the Trichet leadership in its contribution to euro area crisis resolution: two late-2011 rate cuts have been followed by a further 0.25% reduction in policy rates in July; the February LTRO was the second sizeable injection of medium-term liquidity into bank funding markets while most recently it has unveiled its Outright Monetary Transactions (OMT) tool. These developments have served to lower the absolute levels of short-term rates in euro money markets, both directly by lowering the key policy rates and by reducing the risk premia therein.

With short-term liquidity in abundance, it is the ECB's deposit rate rather than its refinancing rate that has for some time been the effective floor for short-dated market rates. So while the 'main' policy rate (as many refer to the refi rate as) currently stands at 0.75%, the rate which the ECB pays for bank deposits is zero (the depo is lower than the rate at which the ECB supplies funds reflecting the desire to disincentivise banks from holding deposits with the central bank). On top of that, the ECB's actions have helped produce a major decline in the liquidity and credit risk premia in interbank markets by providing an assured source of liquidity for the sector, in the process also helping to allay fears about counterparty credit risk (higher levels of funding availability have stemmed the risk of liquidity concerns morphing into solvency worries). Thus, the move to a zero deposit rate and sharp declines in the famed Euribor/OIS interbank risk spread have combined to generate a sharp fall in short-dated money market rates. In particular, the Euribor/OIS spread has narrowed from over 0.9% to close to 0.1% over the course of this year, thus accounting for almost three-quarters of the fall in 3-month Euribor rates from 1.3% to 0.2% over the period (the latter representing an all-time low).

Tighter Libor/OIS spreads have also contributed importantly to downward pressure in sterling and dollar money market rates, thought not quite to the same degree. Helped by spread declines of between 0.35% and 0.5%, 3-month rates have reached record lows in sterling and dollars of around 0.5% and 0.3% respectively.

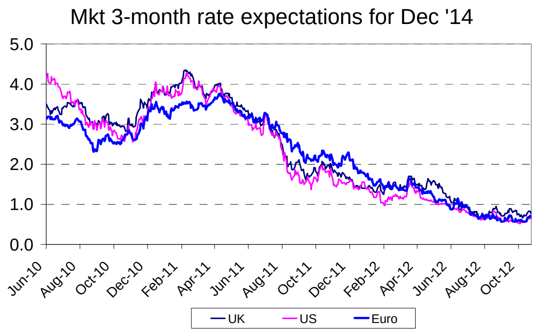
…if anything tightening expectations on a 4-year ahead basis have firmed since the beginning of the year, so the fall in long-term rates is linked mainly to the much lower starting point for the curve…

5-year rates can be thought of as a string of twenty 3-month rates, so the key point of the above is that the large-scale declines in three month rates serve to lower the starting point for the five-year string, thereby imparting strong downward pressure on 5-year rates themselves. In fact, this has been the dominant driver of the move lower in 5-year euro rates, as the cumulative level of upward pressure priced into forward 3-month rates as one looks out several years ahead is actually a bit larger now than at the beginning of the year at around 1.4% vs. just over 1% on a four year ahead horizon (see graph; note in this graph we use the four year ahead point and not five for data availability reasons). The same is also true in sterling 5-year rates, while in dollars the market has scaled back the level of upward movement in rates discounted over the four-year ahead period, aided by explicit guidance from the Fed that policy rates are not likely to move until mid-2015.

So while markets continue to price in some modest upward moves in short-term rates over the coming years, the lower starting position for 3-month rates now vs. earlier in the year has had the effect of pulling down the average of the string of three month rates over the full five-year ahead period.

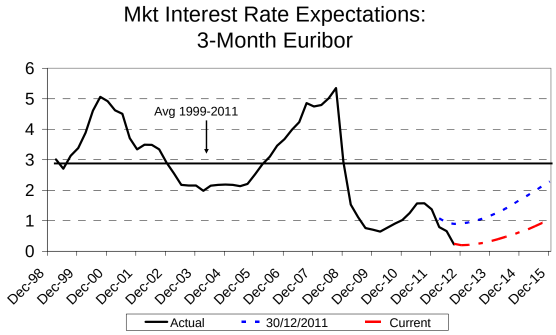
…markets continue to price in a ‘low for long’ rate environment…

Looking forward, the outlook for long-term rates hinges very importantly on the evolution of the broader macro-financial environment. On this score, as the sections above outline, we remain concerned about some important downside risks, including from both the US and Europe where policy formulation and implementation risks linked to the fiscal cliff and the debt crisis respectively have the potential to cause problems in the weeks and months ahead. Indeed, our base case anticipates the need for some additional monetary stimulus to address such risk factors. In the case of the ECB, we expect a further refi rate cut which could well result in the deposit rate being cut to negative territory, while the Fed is also expected to extend its asset purchase programme (a further move from the Bank of England looks less likely following some recent improvement in UK growth figures, but Mr King et al still clearly retain a bias to ease policy again if needed). By design these measures are intended to lower market rates, and so despite some recent back up in swap rates, we expect the recent lows to be revisited across all three markets in the months ahead.

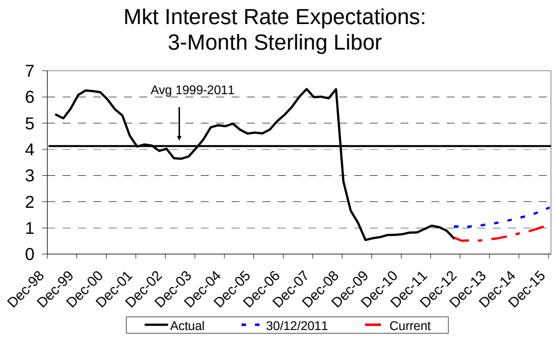


In euros, a sub-zero deposit rate would impart further downward pressure on overnight and other short-dated rates while the provision of further stimulus in the US (and possibly UK) would likely see further downward pressure on government bond yields in those and other related markets including swaps. More generally, with central banks still in stimulus-providing mode, markets are, for a time at least, likely to pare back their expectations regarding the timing and extent of future normalisation of the rate environment.

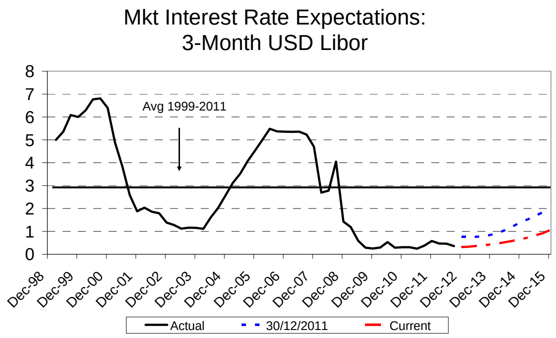
…in the euro zone …



…the UK…



…and in the US…



Such a scenario would take 5-year rates in euros and sterling back below 1% in the period between now and Q1 of next year, while the dollar equivalent may revisit its recent low of around 0.8%.

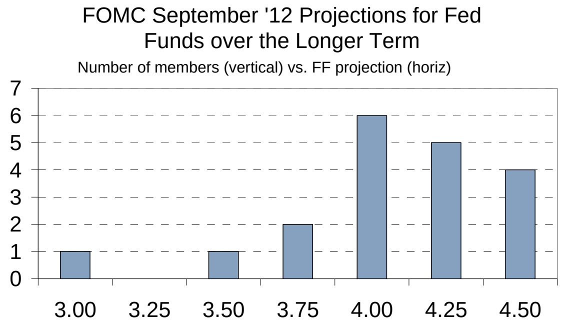
But our base case does anticipate the lifting of at least some of the prevailing economic, financial and policy uncertainty over the course of 2013. In this respect, while we expect only a gradual recovery, we do expect economic conditions to be on a broadly improving trajectory in the major economies through next year. And we anticipate that investor confidence in the recovery will grow, in an environment of fading, though not eliminated, concern about economic and financial tail risks, as policy-makers on both sides of the Atlantic are assumed to make progress on key areas including addressing the US fiscal outlook and strengthening the institutional underpinnings of EMU.

Against this broader backdrop, we expect that 5-year rates will trend modestly higher over the course of next year. With US growth and recovery dynamics looking better-established than in the euro zone or UK, we expect that US long-term rates will probably rise by more than their euro and sterling equivalents. We target a move in 5-year dollar swaps towards the 2% level by the end of next year, and expect the euro and sterling equivalents to push towards the 1.75% mark.

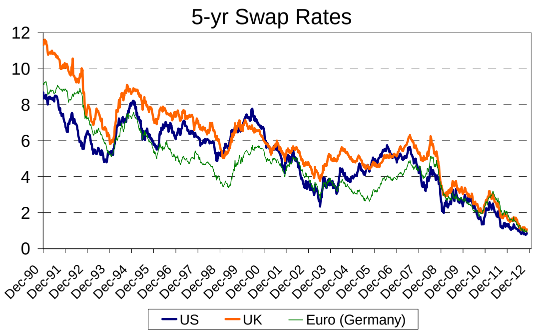
We think our near-term outlook for swap rates is subject to two-way risk linked to various factors. For example a Romney victory in the US Presidential Election could be seen as 'risk-positive' and push both stocks and long-term rates higher. Similarly, the incoming economic news has generally been a bit better than expected lately, while recent ECB policy announcements have reduced concern about euro zone tail risks: a continuation of such trends would likely impart some upside to the outlook for market rates in the weeks ahead. Against that, equity markets have been struggling of late in the face of concerns about the earnings outlook, thus capping the upside for rates and creating the potential for some downside if the stock market sell-off intensifies.

However, looking at the bigger picture, we believe that the medium-term risks around the outlook for long-term rates are skewed to the upside. It is certainly easy to understand how long-term rates have gotten to where they have given the enormity of the economic and financial crisis with which policy-makers have been grappling. Furthermore, our central view is that central banks have yet further work to do in the months ahead in laying the foundations for a more enduringly stable macro-financial environment. In this context, we think it is probably too soon to declare that the lows in rates are

…while the Fed clearly remains very dovish at present, most of its rate-setting committee members agree that official rates will likely need to rise to 4% or higher over the longer term …



…a prospect that puts the exceptionally low level of long-term rates in helpful context



behind us and that swap rates are now set to turn decisively higher. But if economic and financial conditions show the kind of gradual improvement we expect over the course of next year, we think it will be natural for the market narrative to shift from speculation about the form and timing of the next bout of stimulus, to discussions around the when and how central banks begin will begin to pull back from the extremely high levels of monetary accommodation which have been put in place. Of course, the central banks don't wish to encourage such a transition at present, as the resulting back-up in rates would itself produce an undesirable tightening of financial conditions. That is why the Fed is being so explicit in its signal about not moving away from near-zero rates until mid-2015 or later. But forward-looking markets will begin to anticipate the beginning of the policy normalisation process well in advance of any formal shift in guidance from central bankers, and certainly long before any actual shift in the policy stance itself.

The mantra of 'low for long' has, with justification, become a very well-established theme in interest rate markets. However, it would be complacent for treasury risk managers to assume that interest rates, short term or long term, will remain at such extremely low levels indefinitely. It is worth reiterating a point we made in a prior update, which is that, on average, the members of the Fed's interest-rate setting committee - the FOMC - view that the appropriate level of official interest rates in the US over the long-run as being at or above 4%. (Neither ECB nor Bank of England policy-makers provide equivalent information so we use the Fed's guidance for illustrative purposes). That's a very long way from the prevailing level of 0-0.25%, and we are certainly not suggesting that official rates will get even near those levels on the time horizon covered in this report (the end of next year). But what we do wish to flag is that markets will anticipate the eventual normalisation of official interest rates well in advance. Furthermore, market sentiment can change quickly, especially at cycle turning points, and while the timing of associated shifts in market rates is impossible to predict, it can result in rapid and potentially large moves higher. With long-term rates hovering not far from all-time record lows, this is a risk to which the forward-looking treasurer should be attuned in developing a strategic approach to the effective management of interest rate risk over the medium to long-term.

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Over-the-counter (OTC) derivates can involve a number of significant and complex risks which are dependent on the terms of the particular transaction and your circumstances. In the event the market has moved against the transaction you have undertaken, you may incur substantial costs if you wish to close out your position.

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